The Great Recession of 2009

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Commentary

Some economists in the U.S. have started to talk about the Great Recession of 2009 when analyzing the current economic downturn. In the U.S. alone, home equity lost, between 2006 and 2008, $4.2 trillion; the value of retirement assets has declined by $2.3 trillion; while other investments and savings show losses of an additional $2.5 trillion. Total losses add up to more than 60 percent of U.S. GDP. Martin Wolf, writing in the Financial Times, estimates that the current rate of decline of manufactured output in the U.S. compares with that of the Great Depression. Meanwhile, the World Bank has announced that real global GDP will decline in 2009 for the first time since 1945; while the World Trade Organization forecasts that trade volume will decline by 9% this year, the sharpest downturn in 62 years. In sum, all around the world economists are seeing data not seen in at least 50 or 60 years.

Governments in the U.S. and Puerto Rico are betting on old-fashioned economic stimulus spending to jumpstart their ailing economies. However, for stimulus spending to do its trick it must be complemented by additional household spending and new bank lending. In economists' jargon this additional spending and lending is necessary to set off the fabled "multiplier effect," whereby one dollar of government spending generates more than one dollar of economic activity. The problem is that current weaknesses in household finances and in the financial sector may dilute the multiplier effect that should accompany and amplify increased government spending.

On the household side, Roger Altman estimates that the net worth of U.S. households declined by 20 percent between mid 2007 and the end of 2008. This decline in net worth was due largely to the collapse of housing prices and the precipitous drop in equity markets experienced during that period. According to Altman, this reduction is particularly significant when we take into account that average family income in the U.S. has been falling since 2000, while average household debt amounted to 130 percent of household income in 2008.

These factors have combined to generate a strong negative wealth effect. As households feel less wealthy due to the decline in home and financial asset values, they reduce consumption and increase savings. Indeed, personal savings rates have increased to nearly 5 percent in the U.S., up from close to zero in 2005. Given this scenario, Altman does not foresee strong growth in U.S. consumption spending, which accounts for 70 percent of U.S. GDP, until 2011.

On the financial side, the International Monetary Fund estimates that the deterioration in U.S.-originated assets will reach $2.7 trillion by the end of next year; while total write-downs on a global basis could add up to $4 trillion, two-thirds of which would be incurred by banks. So far, banks and insurers, mostly in the U.S., have owned up to only $1.29 trillion in toxic assets. In addition, banks are now seeing "plain vanilla" losses from mortgages, commercial loans, and credit cards due to the effects of the current recession. All these losses are eating into the banks' capital, limiting their capacity to lend. Going forward, it is clear that banks and other financial institutions will need even more capital as balance sheets continue to deteriorate. Can the U.S. government afford to inject another $1 trillion into U.S. banks? Can it be done without nationalization? Is there political support for such a move?

It is impossible to answer those questions with any certainty right now. However, let's assume that U.S. financial institutions require an additional capital injection of $1 trillion during the next year. Assume further that the U.S. government is willing to put up half that amount, leaving it to financial institutions to come up with the other $500 billion.

What options are there for the banks? Unfortunately, not many. In normal times, financial institutions could raise capital in the equity markets. However, given current stock prices, that is not a realistic alternative. Financial institutions could instead try to de-leverage by convincing their bondholders to enter into debt for equity swaps. An interesting idea, but highly unlikely to occur in the absence of federal legislation, forcing bondholders to do so. Another alternative would be for banks to shrink back their balance sheets to bring capital ratios back into line with total assets. However, this would entail a massive credit contraction in order to fully shrink the banks' balance sheets in proportion to their decline in capital — generating a credit crunch that would certainly deepen and prolong the recession. Finally, banks could seek to survive by merging. However, this alternative would be open only to a few relatively stable banks and the number of potential partners, outside of China, is considerably limited. Thus, nationalization looms larger everyday as the most feasible solution in this environment.

In sum, there is no "cookbook" recipe to get us out of the current recession. All available alternatives are fraught with risk and require difficult trade-offs. Keynesian stimulus will help and it will certainly not do any harm, at least in the short term, but it is not sufficient to pull us out of this "balance sheet" recession. It appears we are in for a slow, painful economic restructuring that may take two or three years to fully play out. Yes, this is definitely beginning to look like the recession Grandpa used to talk about.

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